No. 10167

In the United States Circuit Court of Appeals for the Ninth Circuit

COMMISSIONER OF INTERNAL REVENUE, PETITIONER,

v.

COLUMBIA NATIONAL BANK, A CORPORATION, RESPONDENT.

ON PETITION FOR REVIEW OF THE DECISION OF THE UNITED STATES BOARD OF TAX APPEALS

BRIEF FOR THE RESPONDENT

THOMAS P. GOSE,
JOHN F. WATSON,
Counsel for Respondent.

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CITATIONS

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Commissioner of Internal Revenue, petitioner,

v.

Columbia National Bank, a Corporation, respondent.

BRIEF FOR RESPONDENT

STATEMENT

The bad debts collected in 1939 were bank loans of capital assets made to customers in the regular course of business and afterward charged off as worthless at the request of the National Bank Examiner (R. 34, 35, 37, 41,) resulting in such impairment of the Bank's capital structure as to make necessary a voluntary assessment of shareholders and also a reduction of capital stock in the sum of $50,000 (R. 38-40). The recoveries in each instance were much less than the net loss as shown by taxpayer's income tax return for the charge-off year (R. 16). Taxpayer's books of account have been kept and income tax returns made on a cash basis. (R. 17).

SUMMARY OF ARGUMENT

Respondent maintains that the decision of the Board of Tax Appeals should be affirmed because:

1. The bad debt recovery was not taxable as income

as its deduction in charge-off year had not resulted in any tax benefit.

2. The bad debt recovery was not income as that term is used in the Acts of Congress but was a capital recovery.

3. The bad debt recovery was not income as that term is used in the Sixteenth Amendment, and any Act of Congress or Treasury Regulation calling for the taxation of same as income would be unconstitutional.

ARGUMENT

I

The case of *Helvering v. State-Planters Bank and Trust Company,* decided by the Fourth Circuit Court of Appeals August 18, 1942, if it is to control, leaves little to be said for Respondent on the subject of non-taxable bad debt recoveries under the present Statutes and Regulations. That Court sees no difference in principle between recovery of a debt where the deduction in the charge-off year gave no tax benefit, and a recovery where the deduction had resulted in a reduction of the tax. The doctrines of election and estoppel are applied as a basis for the decision. We believe it very doubtful that the facts in the State-Planters case justified the application of either doctrine. At any rate they cannot properly be applied in the instant case. Respondent Bank had no choice or election or option. The Bank Examiner said the items were to be charged off—and that was all there was to it. The taxpayer in reporting these charge-offs as deductions was merely complying with the command of the law. That should not be construed as an estoppel. The deduction having resulted in no tax benefit to the taxpayer and no loss of revenue to the Treasury Department, the element of adverse effect is wholly lacking.

United States v. Scott and Sons, 1934—C. C. A. 1, 69 Fed. (2d) 728, 732.

The cases cited as authority for the position taken by the Circuit Court of Appeals in the Fourth Circuit do not, as we read them, fully support the Court's position. In *Putnam National Bank v. Commissioner,* 50 Fed. (2d) 158, it does not appear that there had been no tax benefit from the deductions.

In *Commissioner v. Liberty Bank and Trust Co.,* 59 Fed. (2d) 320, it appears affirmatively that there was a tax benefit. The Court says, (p. 324):

> "The Commissioner contends that the taxpayer, having asserted in its returns for the former years that the debts were ascertained to be worthless and charged off, and having received the benefit of such assertion, is now estopped." etc."

In *Askin and Marine Co. v. Commissioner,* 66 Fed. (2d) 776, it seems to have been assumed that there had been a tax benefit and that therefore the taxpayer was estopped. It also appears that the taxpayer's books of account had been so kept as to put it on what amounted to an accrual basis.

In *Rossin & Sons v. Commissioner,* 113 Fed. (2d) 652, the taxpayer kept its books on an accrual basis and it does not appear that there had been no tax benefit from the charge-off.

Under the decision of the State-Planters case the taxpayer is to be penalized any way he turns. If he fails to report the charge-off as a deduction in the charge-off year, it is lost to him forever and he pays income taxes which he does not rightfully owe, and, in addition, has no assurance that he will not be required to pay income taxes on all later recoveries. If he does deduct, he thereby incurs a tax on all later recoveries—a

tax many times larger than that saved by the deduction. The State-Planters case entirely overlooks the sense in which the words "allowed as a deduction" are used in the Statutes and Regulations. The mere reporting in income tax returns of charge-off items as losses does not constitute them a deduction or call for their allowance as such until applied to reduce something. For instance, in 1930, the taxpayer reported charge-offs of $98,674.20 but used only $55,039.28 as a deduction for tax purposes. In other words, $43,634.92 of the charge-offs were not deducted from anything nor allowed as a deduction against any income. Of course we have here two conflicting theories. Petitioner in his brief (P. 12) figures like this:

Total debt charge-off	$98,674.20
Net loss for year of charge-off	43,634.92
Tax benefit	$55,039.28

and would apply all subsequent recoveries against this tax benefit figure and tax same until it has been used up. He just naturally thinks in terms of getting revenue. The taxpayer, however, figures like this:

Total debt charge-off	$98,674.20
Portion used to reduce tax	55,039.28
Amount not used as a deduction against taxes	$43,634.92

and would apply all subsequent recoveries against this figure as tax free until same has been used up. The taxpayer naturally thinks that it should be fair to itself, particularly when there is neither gain nor profit for the Bank in any recovery, even though not taxed at all. As between the two theories, it is submitted that the Court should favor the one most consonant with equity, (*Helvering v. Lazarus & Co.*, 308 U. S. 252, 84 L. ed. 226, 230), and any doubt should be resolved in favor of the taxpayer. Old Colony R. R. Co., v. Commissioner, 284 U. S. 552, 76 L. ed. 484.

Burnet v. Sanford and Brooks Co., 282 U. S. 359, 75 L. ed. 383, is used in G. C. M. 22163 (Prentice Hall Inc.—

Fed. Tax Serv. 1940, Par. 66252) (appendix herein, p. 13) and in the State-Planters case on which to build a doctrine under which no business concern can long survive during fluctuating conditions such as we have experienced in the last twelve years. To fasten on them the rule of the "annual period" and treat bad debt charge-offs as ordinary business expenses will certainly kill the tax goose. Justice Stone in *Burnet v. Sanford,* supra, intended no such application of the rule. He was referring to the recovery of expenses incurred and paid in the course of performance of work under contract as being different from recovery of capital investments. He says: "They were not capital investments, the cost of which, if converted, must first be restored from the proceeds before there is a capital gain taxable as income." (Cit. *Doyle v. Mitchell Bros. Co.* 247 U. S. 179, 62 L. ed. 1054, 1059). In the Doyle case the Court said: "In order to determine whether there has been gain or loss and the amount of the gain, if any, we must withdraw from the gross proceeds an amount sufficient to restore the capital value that existed at the commencement of the period under consideration." The point with which the decision of *Burnet v. Sanford,* supra, dealt was the year in which the recovery was taxable. Here we are dealing not with income but with capital and the only question is whether the taxpayer has impliedly agreed that it shall be taxed as though it were income. Continuity in income reporting and taxation, as well as the exigencies of the banking business and practical accounting require projection from one year into one or more succeeding years. *Nat. Bank of San Antonio v. Commissioner,* 95 Fed. (2d) 622. It is significant that in the statutory definition of gross income (26 U. S. C. A. Sec. 22) quoted on page 2 of Petitioner's brief, the word income is used in the sense

of gains or profits. There can be no gain or profit in recovering a bad debt, except only as one has used same to reduce taxes.

II

The bad debt recovery was not income as that term is used in the Acts of Congress but was a capital recovery. As pointed out above, the Respondent takes the position that the recoveries in question being far less in each instance than the net loss of the charge-off year have never been "allowed as a deduction" against income. The only basis for the Commissioner's deficiency assessment must be found in the Rules and Regulations and Opinions promulgated by the Treasury Department. Where is the statute which says that any bad debt recovery is income or is taxable as such? Petitioner in his brief cites none. The Court in the State-Planters case refers only to the statute (26 U. S. C. A. 23. (k) (1)) providing for the use of charge-offs as deductions and then turns to the Treasury Regulations to find anything authorizing such a tax. But even under the Regulations, the only recoveries held to be taxable are recoveries previously "allowed as a deduction" against income. The language of the Regulation (Sec. 19.23 (k)-1.(b), is as follows: "Any amount subsequently received on account of a bad debt or on account of a part of such debt previously charged off *and allowed as a deduction for income tax purposes,* must be included in gross income for the taxable year in which received." The Secretary of the Treasury cannot by Regulations alter or amend a revenue law. All he can do is to regulate the mode of proceeding to carry into effect what Congress has enacted. *Morrill v. Jones,* 106 U. S. 466, 27 L. ed. 267. The only authority conferred or which could be conferred by the

Statute is to make Regulations to carry out the purpose of the Act—not to amend it. *Miller v. U. S.* 294 U. S. 435, 79 L. ed. 977, text 981. It can hardly be contended that in the matter of taxation of bad debt recoveries the Rules and Regulations of the Treasury Department are entitled to any respect as being consistent and well-settled. The following administrative history is taken from the opinion of the Federal District Court for the Eastern District of Pennsylvania in the case of *Philadelphia National Bank v. Rothensies* (Mar. 1942) 43 Fed. Supp. 923:

> "Prior to 1937 the Bureau of Internal Revenue had held that amounts subsequently recovered on account of debts previously charged off and allowed as a deduction for income tax purposes must be included as gross income for the year in which received, whether or not the prior allowance of the deduction had resulted in a benefit to the taxpayer. This view had been sustained by the Board of Tax Appeals in *Lake View Trust and Savings Bank v. Commissioner,* 27 B. T. A. 290 (1932). However, in 1937, the Bureau promulgated G. C. M. 18525 (modified later by G. C. M. 20854, to cover the case of voluntary charge-offs by banks) and in 1939 acquiesced in two decisions of the Board of Tax Appeals which held that subsequent recoveries were to be included as income in the year of recovery only if the earlier deductions had accomplished a reduction in tax liability. See *Central Loan & Investment Co. v. Commissioner,* 29 B. T. A. 981, and *National Bank of Commerce of Seattle v. Commissioner,* 40 B. T. A. 72.
>
> "In 1940 the Bureau, by G. C. M. 22163, again

> reversed its position, revoked the earlier rulings, and withdrew the acquiescences. G. C. M. 22163 ruled that the recoveries constituted taxable income whether or not the prior allowance of the deduction had resulted in any tax benefit to the taxpayer."

In that case it was held that the recovery was not income but capital and that the only conditions under which same might be taxable would be when used as a deduction to reduce taxes, on the theory that the taxpayer would be thereby estopped. In reaching this conclusion the Court said:

> "I think that it must be agreed that the repayment of a debt is a return of capital. To my mind, no process of reasoning can make it anything else. Being in fact capital, it does not become income merely because it is not returned as agreed or when expected, or even if the owner concludes in his own mind that he will never get it again. To justify a tax upon the repayment of of a debt by referring it to the statutory definition of gross income would undoubtedly extend the statute beyond the constitutional powers of Congress.
>
> "But a taxpayer may voluntarily submit to an otherwise illegal or unconstitutional imposition, and, if it is a condition of some benefit which is tendered to him, his acquiescence will be assumed or implied from his acceptance of the benefit. Deductions allowed by law from gross income are not matters of right but of grace. When a taxpayer claims and is allowed a bad debt against his taxable income there is no difficulty in finding an implied consent to be

taxed in respect of future recovery of the bad debt, whether or not it is actually income. Whether this be called an implied agreement of waiver for valid consideration or an estoppel, is not of great importance."

Petitioner's Chief Counsel in 1939 promulgated G. C. M. 20854 in which he had this to say:

"It is well settled that in the ordinary case amounts received in repayment of loans do not constitute income but are reimbursements of capital. (*Charles M. Howell, Admr.,* 21 B. T. A., 757, petition to review dismissed on motion of the Commissioner, *Burnet v. Howell, Admr.,* 59 Fed. (2d) 1053.) * * * * Unless a taxpayer has already recovered his capital for income tax purposes, recoveries with respect to a debt, in the opinion of this office, can not be considered as income.

"In any case in which a bad debt has been allowed as a deduction and has had the effect of offsetting taxable income (meaning, for present purposes, income which would be the basis for the computation of a tax liability), the taxpayer has, to that extent, in effect had the benefit of a recovery of capital for income tax purposes. In determining the extent, if any, to which a taxpayer has thus benefited, the credits against net income provided in the Revenue Acts must be taken into account. To the extent that a deduction does not result in such a benefit to the taxpayer, the deduction cannot be said to have accomplished a return of capital. Until a taxpayer has had the income tax equivalent of a full return of the capital represented by his debt, there is no

valid ground for treating as income any amount recovered in recovery of the debt. Accordingly the above-quoted provisions of the regulations are not to be interpreted as requiring the inclusion in income of amounts received in recovery of a debt until the taxpayer has fully recovered the capital represented by the debt either by the means referred to above or partly by such means and partly by repayment by the debtor."

What about the recovery of $1070 charged off in 1937 without any tax benefit? In a ruling promulgated Dec. 11, 1940, by the Commissioner and approved by the Acting Secretary of the Treasury (Com. Cl. H. Inc. 1941 Tax Service, Par. 6114) he said:

"This office concurs in the view that it would be inequitable to treat, as taxable income, amounts received in recovery of debts previously deducted where the deduction did not result in a tax benefit, if the deduction was taken in an income tax return filed during the period that there was outstanding a published ruling of the Bureau to the effect that amounts received in recovery of debts previously deducted do not constitute taxable income unless the prior deduction resulted in a tax benefit.

"Accordingly, pursuant to authority contained in Section 3791 (b) of the Internal Revenue Code, the ruling contained in G. C. M. 22163, supra, will not be applied to recoveries upon debts charged off and deducted by banks or other corporations subject to supervision by Federal authorities (or by State authorities maintaining substantially equivalent standards), where such charge-offs were at the direction of Federal or

> State superivsory officers, if the deduction did not result in a reduction of the Federal income tax liability, provided the deduction was taken in an income tax return filed during the period June 28, 1937, to July 8, 1940, during which period G. C. M. 18525, supra, remained unmodified."

III

Any Act of Congress or Treasury Regulation for the taxation of these recoveries as income would be unconstitutional. By the Tariff Act of August 15, 1894, Congress undertook to impose a tax on "incomes." The United States Supreme Court in *Pollock v. Farmers' Loan and Trust Company*, 157 U. S. 429, 39 L. ed. 759, 158 U. S. 600, 39 L. ed. 1108, held the Act unconstitutional as imposing a direct tax without apportionment as to census, and in violation of Art. 1, Section 2, Clause 3, and Art. 1, Sec. 9, Clause 4 of the Federal Constitution. Thereafter in 1909 was proposed and in 1913 ratified by the required number of States, the 16th Amendment authorizing Congress to tax "incomes" without apportionment among the several states. So, it is *income* only which can be taxed without apportionment.

> "Income within the meaning of the 16th Amendment is the fruit that is born of capital. * * *. With few exceptions, if any, it is income as the word is known in the common speech of men."

These are the words of the late Justice Cardozo in *U. S. v. Safety Car Heating and L. Co.*, 297 U. S. 88, 80 L. ed. 500, 507. In *Eisner v. McComber*, 252 U. S. 189, 64 L. ed. 521, it was held that, regardless of any attempt on the part of Congress to define it otherwise, the word

"Income" as used in the 16th Amendment is correctly defined in *Doyle v. Mitchell Bros. Co.,* 247 U. S. 179, 62 L. ed. 1054, 1059, as "*gain* derived from capital, from labor, or from both combined." In *Taft v. Bowers,* 278 U. S. 470, 481, 73 L. ed. 460, 463, the Court said: "The 'gain derived from capital' within the definition, is 'not a gain accruing to capital, nor a growth or increment of value in the investment, but a *gain,* a *profit,* something of exchangeable value proceeding from the property *severed from the capital* however invested, and coming in, that is received or drawn by the claimant for his seperate use, benefit and disposal.' Cit. U. S. *v. Phellis,* 257 U. S. 156, 169, 66 L. ed. 180, 183). If the donor had sold it (stock) at market value, the excess over the capital he invested, (cost) would have been income therefrom and subject to taxation under the 16th Amendment."

Italics where used in this brief are ours.

Respectfully submitted,

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John F. Watson,

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October, 1942.

APPENDIX

G. C. M. 22163.

Reconsideration has been given to G.C.M. 18525 (C.B. 1937-1, 80) and G.C.M. 20854 (C.B. 1939-1 (Part 1), 102), both relating to bad debts, with particular attention to the question of the proper treatment for Federal income tax purposes of recoveries of debts charged off and claimed as deductions in prior years.

The last paragraph of G.C.M. 18525, supra, reads as follows:

> The deductions for bad debts contemplated by the clause "allowed as a deduction for income tax purposes" (as used in (f), (g), (h), and (i) above) refer to deductions for bad debts which accomplished a reduction in tax liability and do not refer to deductions for bad debts in cases in which the taxpayer, on account of other allowable deductions, had no net income irrespective of the deduction for bad debts.

G.C.M. 18525, supra, was published to illustrate the application of the provisions of article 191 of Regulations 77 and article 23 (k)-1 of Regulations 86, both as amended by Treasury Decision 4633 (C.B. XV-1, 118 (1936)), and the provisions of the last paragraph of article 23 (k)-1 of Regulations 94, which read as follows:

> Where banks or other corporations which are subject to supervision by Federal authorities (or by State authorities maintaining substantially equivalent standards) in obedience to the specific orders of such supervisory officers charge off debts in whole or in part such debts shall be conclusively presumed, for income tax purposes, to be worthless or recoverable only in part, as the case may be, but in order that any amount of the charge-off may be allowed as a deduction for any taxable year it must be shown that the charge-off took place within such taxable year.

The last paragraph of G.C.M. 18525, supra, in effect provides that there shall be no adjustment of the basis of a debt as the result of the prior deduction of such debt in whole or in part unless such prior deduction accomplished a reduction in tax liability. The primary purpose of the incorporation of that paragraph in G.C.M. 18525 was to set forth the rule that amounts recovered upon debts deducted in prior years do not constitute taxable income unless such deduction resulted in a reduction in tax liability. Thereafter, in I.T. 3172 (C.B. 1938-1, 150) there was set forth the method for determining the extent of the benefit derived by the deduction of bad debts. That ruling was later modified by I.T. 3256 (C.B. 1939-1 (Part 1), 172), in accordance with the recommenda-

tion contained in G.C.M. 20854, supra, which is discussed in the next paragraph of this memorandum.

G.C.M. 18525, supra, involved only bad debt deductions by banks or other corporations subject to supervision of Federal or State authorities as a result of the conclusive presumption of partial or total worthlessness established by orders of Federal or State supervisory officers. However, in G.C.M. 20854, supra, it was held that the principle stated in G.C.M. 18525, that recoveries of debts previously deducted do not constitute taxable income unless the deduction of the debts in prior years resulted in a reduction in tax liability, is equally applicable in cases of recoveries of debts voluntarily deducted by banks or other corporations subject to Federal or State supervision and to recoveries of debts deducted by other taxpayers. It was held that in any case in which a bad debt has been allowed as a deduction and has had the effect of offsetting taxable income, the taxpayer has, to that extent, in effect had the benefit of a recovery of capital for income tax purposes, but that amounts received in recovery of the debt should not be treated as taxable income until the taxpayer has fully recovered the capital represented by the debt either by such means or partly by such means and partly by repayment by the debtor.

In I.T. 3278 (C.B. 1939-1 (Part 1), 76) the principle of G.C.M. 20854, supra, was extended to amounts of State taxes refunded or credited, and it was held that the amount refunded or credited should be treated as taxable income only if and to the extent that it is in excess of the portion of the prior deduction which did not have the effect of offsetting taxable income. That ruling (I.T. 3278) modified Mimeograph 3958 (C.B.XI-2, 33 (1932)) and Mimeograph 4564 (C.B. 1937-1, 93), relating to the taxable status of refunds of customs duties and taxes.

In Central Loan & Investment Co. v. Commissioner (39 B.T.A. 981, acquiescence, C.B. 1939-2, 6), the Board of Tax Appeals applied the rule stated in I.T. 3278, supra, in reference to taxes, citing in its opinion G.C.M. 18525, supra, and G.C.M. 20854, supra. In the National Bank of Commerce of Seattle v. Commissioner (40 B.T.A. 72, acquiescence, C.B. 1939-2, 26, on recovery of bad debt issue), the Board applied the said rule to bad debts, again citing the above-mentioned General Counsel's memoranda. In neither of these Board of Tax Appeals decisions did the Board refer to its prior decision in Lake View Trust & Savings Bank v. Commissioner (27 B.T.A. 290), in which it was held that amounts received in recovery of debts allowed as deductions in prior years constitute taxable income irrespective of whether such prior deductions had the effect of reducing the taxpayer's taxable income.

Section 19.42-1 of Regulations 103, relating to the Internal Revenue Code, provides in part as follows:

> * * * Bad debts or accounts charged off subsequent to March 1, 1913, because of the fact that they were determined to be worthless, which are subsequently recovered, whether or not by suit, constitute income for the year in which recovered, regardless of the date when the amounts were charged off. * * *

This regulation has been in effect in all of the income tax regulations of the Treasury Department to the present time.

Section 19.23(k)-1 of Regulations 103 provides in part as follows:

> * * * Any amount subsequently received on account of a bad debt or on account of a part of such debt previously charged off and allowed as a deduction for income tax purposes, must be included in gross income for the taxable year in which received. * * *

This regulation has been in effect in all of the income tax regulations of the Treasury department from article 151 of Regulations 62 to the present time.

Prior to the issuance of G.C.M. 18525, supra, the Bureau had consistently held that any amount subsequently recovered on account of a debt previously charged off and allowed as a deduction for income tax purposes must be included in gross income for the taxable year in which received, regardless of whether the prior allowance of the deduction resulted in a benefit to the taxpayer. As pointed out heretofore, in the case of Lake View Trust & Savings Bank, supra, decided prior to G.C.M. 18525, the Board of Tax Appeals sustained the Bureau practice.

Upon reconsideration, it is now the opinion of this office that the rule sustained in the case of Lake View Trust & Savings Bank, supra, is the correct rule to be followed. This conclusion is in accord with the decision of the Supreme Court of the United States in Burnet v. Sanford & Brooks Co. (282 U.S., 359, Ct.D. 277, C.B. X-1, 363 (1931)). The taxpayer in Burnet v. Sanford & Brooks Co. had entered into a dredging contract with the United States and, after having performed for three years at a large loss, abandoned operations and sued the Government for breach of warranty as to the character of the material to be dredged. Judgment was recovered for $192,577.59, of which $176,271.88 was the amount by which its expenses of operation under the contract exceeded receipts from it, and the balance, $16,305.71, represented accrued interest. During the years of operation the taxpayer had returned as gross income the receipts under the contract and had deducted its expenses paid in performing the contract. For all but one of such years the returns showed net losses. The taxpayer failed to return the amount of the judgment as income in the year of receipt, and the Commissioner, therefore, assessed a deficiency. In upholding the action of the Commissioner, the Supreme Court said in part:

All the Revenue Acts which have been enacted since the adoption of the sixteenth amendment have uniformly assessed the tax on the basis of annual return showing the net result of all the taxpayer's transactions during a fixed accounting period, either the calendar year, or, at the option of the taxpayer, the particular fiscal year which he may adopt. * * *

That the recovery made by respondent in 1920 was gross income for that year within the meaning of these sections can not, we think, be doubted. The money received was derived from a contract entered into in the course of respondent's business operations for profit. While it equaled, and a loose sense was a return of, expenditures made in performing the contract, *still,* as the Board of Tax Appeals found, *the expenditures were made in defraying the expense incurred in the prosecution of the work under the contract, for the purpose of earning profits. They were not capital investments,* the cost of which, if converted, must first be restored from the proceeds before there is a capital gain taxable as income. * * * (Italics supplied.)

Under the principle of the Supreme Court's decision in the Sanford & Brooks Co. case, supra, items of expense incurred in carrying on a trade or business do not represent capital investment, the cost of which, if converted, must first be restored before there is a capital gain taxable as income. Bad debts charged off in any business are deductible under a specific provision of the Revenue Acts rather than as ordinary and necessary business expenses. They are, nevertheless, under well-established accounting practices, recognized as operating expenses of the business deductible as such in arriving at the net operating gain or loss for the periods involved. See Finney, Principles of Accounting, 1934 Edition, Volume I, page 37, and Kester, Principles of Accounting, Fourth Edition, pages 46, 116, and 554. Consequently, the amount represented by debts which become worthless and are charged off in the carrying on of a trade or business is not to be considered as an investment of capital which must first be returned in full before taxable income is derived. Under this principle, amounts recoverable in any taxable year upon debts previously charged off and allowed as a deduction should be treated as taxable income regardless of whether the prior allowance of the deduction resulted in a tax benefit to the taxpayer.

It is the opinion of this office, furthermore, that in the case of a bad debt owing to a taxpayer which has not arisen in connection with the carrying on of a trade or business, the recovery of such a debt where it has been charged off and deducted in a prior year constitutes taxable income irrespective of whether the prior allowance of the deduction resulted in a tax benefit. In United States v. Ludey (274 U.S. 295, T.D. 4046, C.B. VI-1, 157 (1927)) it was held that in ascertaining the basis for computing gain or loss in the case of the sale of depletable assets, the original basis thereof must be reduced by the amount of depreciation and depletion allowable as deductions in the years during which the property was held regardless of whether deductions had been claimed. It is to be

observed that the Revenue Act involved in that case did not contain a specific provision requiring such a reduction of basis. It is believed that this case stands for the proposition that, under the broad purposes of the Revenue Acts, a taxpayer is to be charged with having recovered his capital to the extent that the statute permits deductions from gross income on account thereof, regardless of whether the taxpayer took advantage of the deduction privilege provided in the Revenue Acts. See also Hardwick Realty Co., Inc., v. Commissioner (29 F. (2d), 498, certiorari dismissed on motion, 279 U.S. 876), in which it was held that depreciation must be deducted in ascertaining the adjusted basis of depreciable property even though deductions for depreciation in the years sustained conferred no tax benefit.

The case of United States v. Ludey, supra, would seem to indicate that amounts recovered upon a debt, whether or not incurred in business, constitute taxable income if in any prior year such debt constituted an allowable deduction under the applicable Revenue Act, even though such deduction was not claimed and allowed. See S.R. 2940 (C.B. IV-1, 129 (1925)), modified in G.C.M. 20854, supra, in which it was held that under article 52 of Regulations 45, article 51 of Regulations 62, and article 50 of Regulations 65, the amount of a debt written off and allowable as a deduction should be treated as income for the year in which actually recovered. However, in view of the fact that all of the regulations beginning with article 151 of Regulations 62, promulgated under the Revenue Act of 1921, have contained the provision that any amount subsequently received on account of a bad debt or on account of a part of such debt "previously charged off, *and allowed as a deduction for income tax purposes*" (italics supplied) must be included in gross income for the taxable year in which received, taxpayers will not be required to return as income any amounts received in recovery of debts except to the extent that such debts have been previously claimed and allowed as deductions. As indicated above, however, if a debt was allowed as a deduction in whole or in part in a prior year, amounts recovered upon such debt constitute taxable income in the year of the recovery to the extent previously allowed as a deduction, *irrespective of whether the allowance of the deduction resulted in a tax benefit to the taxpayer.*

The foregoing is consistent with the manner in which the Bureau computes the gain or deductible expenses to a corporation upon the retirement of its bonds. Section 19.22(a)-18 of Regulations 103 provides that if bonds are issued by a corporation at a discount, the net amount of such discount is deductible and should be prorated or amortized over the life of the bonds. It further provides that if the corporation purchases

any of such bonds at a price in excess of the issuing price plus any amount of discount already deducted, the excess of the purchase price over the issuing price plus any amount of discount already deducted is a deductible expense for the taxable year. It is provided, however, that if the corporation purchases any of such bonds at a price less than the issuing price plus any amount of discount already deducted, the excess of the issuing price, plus any amount of discount already deducted, over the purchase price is gain or income for the taxable year. In computing the income or deductible expense under the regulations, the Bureau has adopted the view that it is immaterial whether the deductions on account of bond discount resulted in a tax benefit to the taxpayer.

In view of the foregoing, G.C.M. 18525, supra, is modified by eliminating the last paragraph thereof; G.C.M. 20854, supra, is revoked; and S.R. 2940, supra, is modified to accord with the view expressed herein. It is recommended that I.T. 3172, supra, and I.T. 3256, supra, be revoked; that I.T. 3278, supra, be modified; and that the acquiescence in Central Loan & Investment Co. v. Commissioner, supra, and the acquiescence in the National Bank of Commerce of Seattle v. Commissioner, supra, be withdrawn. (G.C.M. 22163; 1940-28-10324.)